SCS Agency
Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Ortiz | Analyst: Marion Mann DeJong | Bill Number: AB 1633

Related Bills: AB 1488, AB 1631 | Telephone: (916) 845-6979 | Introduced Date: 01/05/98

SB 1166, SB 1425 | Attorney: Doug Bramhall | Sponsor:

SUBJECT: Taxpayers' Bill of Rights/Shift Burden of Proof

SUMMARY

This bill would incorporate into state law some of the federal Taxpayer Bill of Rights 3 provisions proposed by Congress. Specifically, this bill would:

1. Under certain circumstances, shift the burden of proof from taxpayers to the department in court proceedings (Section 18404). See Burden of Proof on page 2.

2. Expand the "innocent spouse" relief provisions by allowing proportioned relief (Section 18533). See Innocent Spouse on page 6.

3. Declare the intent of the Legislature that, by year 2007, 80% of all returns should be filed electronically. In addition, require the department to include in its annual report to the Legislature both the department's progress of achieving the goal and legislative changes necessary to assist in meeting the goal (Section 18621.5). See Electronic Filing on page 8.

4. Suspend the statute of limitations for refund claims for a period where the taxpayer is suffering from physical or mental impairment that is expected to result in death or to last for a continuous period of at least one year (Section 19310). See SOL/Financially Disabled Taxpayers on page 10.

EFFECTIVE DATE

This bill would be effective January 1, 1999.

LEGISLATIVE BACKGROUND

In 1988, Congress enacted a Taxpayers' Bill of Rights (TBR) for laws administered by the Internal Revenue Service (IRS). Using the proposed federal TBR as a springboard, California enacted a Taxpayers' Bill of Rights for laws administered by FTB and Board of Equalization (BOE), generally effective January 1, 1989. Subsequently, the Employment Development Department (EDD) TBR was enacted.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Department Director Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X___ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department Director Gerald H. Goldberg 2/20/98	Agency Secretary Date	By: Date:

On July 30, 1996, Congress enacted TBR 2 to provide for increased protection of taxpayer rights in complying with the Internal Revenue Code (IRC) and in dealing with the IRS in its administration of the tax laws. In 1997, California enacted legislation (AB 713, Stats. 1997, Ch. 600) to conform to TBR 2 where applicable.

Currently, Congress is proposing legislation to further expand taxpayer rights and to restructure the IRS. This proposed legislation would implement many of the recommendations of the National Commission to Restructure the Internal Revenue Service.

The House bill, H.R. 2676, is known as the "Internal Revenue Service Restructuring and Reform Act of 1997." H.R. 2676 addresses four broad areas: (1) Executive branch governance of the IRS and personnel flexibilities; (2) electronic filing; (3) taxpayer rights (including shifting the burden of proof); and (4) congressional oversight of the IRS. There are 31 provisions under the taxpayer rights area. The House passed H.R. 2676 on November 5, 1997.

The Senate Finance Committee held widely publicized hearings on the IRS during the fall of 1997. It is expected to hold additional hearings early this year and produce its own "IRS Restructuring" bill (likely S. 1096).

CONSIDERATION

The federal legislation regarding the taxpayer bill of rights has not been enacted. Generally, state legislation is enacted after federal legislation, to allow the state to conform (where applicable) to the new federal law. Further, if AB 1633 is enacted and the federal legislation is not enacted or is revised to be different than AB 1633, taxpayers may be confused by the differences in federal and state law. Thus, state legislation in this area may be premature.

BOARD POSITION

Pending.

1. Burden of Proof

EFFECTIVE DATE

This provision would apply to any court proceeding as of January 1, 1999.

SPECIFIC FINDINGS

Under federal law, taxpayers may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable. Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the assessment is sustained, under the federal appeals system, the Tax Court (which has a small claims division for amounts of $10,000 or less), a

U.S. district court or the U.S. Court of Claims is the first level of judicial review of IRS actions. In these reviews, a rebuttable presumption exists that the IRS's determination of tax liability is correct. Taxpayers have the burden of proving that the IRS's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. This review is an independent judicial review by a trial court upon evidence submitted by the parties. Both the taxpayer and the IRS can bring actions in appellate courts to appeal final adverse determinations, except small claims division determinations, which are binding.

Under current Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (BCTL), taxpayers may be requested by the Franchise Tax Board (FTB) to furnish substantiation of the items reflected on their income tax returns. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

Taxpayers protest the issuance of a proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB. The FTB staff reviews the protest and grants an oral hearing upon request by the taxpayer. The taxpayer's forum for appealing FTB's action on that protest is the Board of Equalization (BOE), as follows:

- if FTB has denied a taxpayer's protest of a proposed deficiency assessment;
- if FTB has denied a claim for refund or failed to act on the claim within six months after it is filed;
- if FTB has disallowed interest on a refund claim; or
- if FTB has issued a "jeopardy" deficiency assessment and denied the taxpayer's charge that collection was not in jeopardy.

The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action was correct. Hence, taxpayers have the burden of producing evidence to show that the FTB's action was incorrect and establishing the merits of their position by a preponderance of the evidence.

In the event of a final adverse BOE decision on an appeal of a proposed deficiency, the taxpayer's recourse is to pay the amount due, and file a claim for refund. After denial of the claim (or a failure by the department to act on the claim within six months) or an adverse BOE decision on a taxpayer's appeal regarding a claim for refund, the taxpayer may bring an action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

This provision would shift the burden of proof from the taxpayer to the FTB for litigation cases provided the taxpayer asserts a reasonable dispute and fully cooperates with the board with respect to the issue in dispute. This provision would not be construed to override any requirement under the PITL, Administration of Franchise and Income Tax Laws and Regulations (AFITL) or B&CTL to substantiate any item.

Policy Considerations

This provision would raise the following policy considerations.

- Generally in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. The taxpayer is the plaintiff in all California Superior Court actions. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.

- Supporters of this proposal point to the discussion of the proposed federal legislation (H.R. 2676). Members of the Ways and Means Committee said they were "concerned that individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the IRS. The Committee believes that the present burden of proof rules contribute to that disadvantage. The Committee believes that, all other things being equal, facts asserted by individual and small business taxpayers that fully cooperate with the IRS and satisfy all relevant substantiation requirements should be accepted. The committee believes that shifting the burden of proof to the Secretary in such circumstance will create a better balance between the IRS and such taxpayers, without encouraging tax avoidance."

- Opponents argue that shifting the burden of proof could lead to reduced compliance and result in more intrusive audits to substantiate the accuracy of an assessment. Residency and unitary audits could be more difficult since the information may be outside the state.

- The burden of proof provision of this bill does not conform to the proposed federal provision. The language provided in this bill does not: (1) limit the burden of proof shift to the smaller taxpayers, (2) define what is considered "taxpayer cooperation," and (3) limit the provision to court proceedings arising in connection with "examinations" commencing after the date of enactment.

- Currently, the taxpayer is asked to substantiate the amounts reported on the return, and deductions are considered to be a matter of legislative grace. The IRC and R&TC have few statutes that specifically require substantiation; the requirement to substantiate an item resting mainly in case law.

Implementation Considerations

This provision would raise the following implementation considerations. Department staff is available to help the author resolve these concerns.

- The terms "reasonable dispute" and "cooperates fully" are not defined. If the intent is to pattern California law after the federal provision, it may be better to conform by referencing the federal provision so that federal regulations (which should be provided by the IRS to clarify these terms) are effective for California purposes.

- Shifting the burden of proof on litigation cases would most significantly affect claims for refund that are deemed denied, residency or unitary cases, and claims in bankruptcy and probate court proceedings. In refund cases, the department may not have had an opportunity to obtain supporting documents from the taxpayer. It is unclear whether the audit staff would be required to seek additional supporting data for all cases to protect the state's interest in the event the case is litigated.

- One significant department workload is assessments based upon federal Revenue Agent Reports (changes to gross income or deductions reported on the federal return). Currently, such adjustments are presumed to be correct. It is unclear whether this provision would remove that presumption and require the department to prove that the changes made to the federal return are correct.

- Currently, FTB retains taxpayer records for a period of three to four years and then destroys them, as authorized under R&TC Section 19530. Shifting the burden of proof to the department may require additional records to be maintained and longer retention of records with increased costs for storage.

- Under certain conditions, this bill would shift the burden of proof to FTB in ascertaining the "income tax liability" of a taxpayer. It is unclear whether the burden of proof would be shifted to the FTB on issues related to penalty and interest. This ambiguity derives from the fact that current law is unclear as to whether penalty and interest are an addition to, and therefore part of, the tax or something separate and apart from the tax.

Technical Considerations

The bill makes reference to the "board" as an apparent reference to the FTB. However, under the PITL, AFITL and BCTL, reference to the "board" means the BOE. Amendments 1 and 2 would change "board" to "Franchise Tax Board."

FISCAL IMPACT

Departmental Costs

The departmental costs associated with this provision are unknown. The costs could increase, however, to the extent that additional supporting evidence would be required on all cases to support the state's position on any potential litigation cases.

Tax Revenue Estimate

This provision would result in unknown revenue losses.

Tax Revenue Discussion

The revenue loss for this bill would be determined by those assessments that may be revised due to incomplete documentation to support the assessment and revenues lost from possible negative effects on voluntary compliance.

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define "fully cooperate."

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of $795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact from reduced self-assessed reporting may result, which could have an effect on departmental audit programs. Because the language of this bill does not conform to the federal proposed legislation, it is not possible to use the federal revenue impact to measure the impact from this bill.

2. Innocent Spouse

EFFECTIVE DATE

This provision would apply as of January 1, 1999.

SPECIFIC FINDINGS

Under current federal law, spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability). To avoid joint liability, a spouse must file as a "married person filing separately."

Current federal law provides relief from liability for tax, interest and penalties for "innocent spouses." To qualify for innocent spouse relief, the innocent spouse must establish all of the following.

- That a joint return was made.
- That an understatement of tax, which exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income (AGI) for the most recent year, is attributable to a grossly erroneous item of the other spouse.
- That in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax.

The specified percentage of AGI is 10% if AGI is $20,000 or less. Otherwise the specified percentage is 25%. Grossly erroneous items include items of gross income omitted from reported income and claims of deductions, credits or basis in an amount for which there is no basis in fact or law.

Under current state law, as with federal law, spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability).

Current state law also provides relief from liability for tax, interest and penalties for "innocent spouses" if it is inequitable to hold that spouse liable for the understatement. To qualify for innocent spouse relief, the innocent spouse must have filed a joint tax return and did not know, or had no reason to know, of the understatement. The spouse must be innocent with respect to the entire understatement.

This provision would expand the innocent spouse relief by allowing proportioned relief to the extent the liability is attributable to the portion of an understatement of tax which the spouse did not know of and had no reason to know (e.g., the spouse had reason to know of $5,000 of unreported income and in fact the other spouse did not report $50,000 of income).

Policy Considerations

This provision would raise the following policy considerations.

- This provision provides an equitable solution for taxpayers who are innocent with respect to a portion of the liability.

- The proposed federal legislation requires the spouse to request relief within a reasonable period of time whereas this provision does not.

Implementation Considerations

It may be difficult to determine what portion of the unreported income or overstated deduction the spouse had no knowledge of.

Technical Considerations

Amendment 3 would clarify that the innocent spouse can receive relief if he or she has some knowledge of an understatement, but lacks knowledge of the extent of that understatement.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

Although an innocent spouse may be relieved of part of his or her tax obligations, the other spouse would be fully liable to pay any tax assessment. While this provision could delay revenue collections and could result in actual revenue losses in cases where the department cannot collect from the other spouse, these impacts in any given year are speculative but may not be particularly significant.

3. Electronic Filing

EFFECTIVE DATE

This provision would apply as of January 1, 1999. This provision would specify that goals regarding electronic filing should be attained by the year 2007.

SPECIFIC FINDINGS

Current federal law and programs provides the taxpayer with the option of filing an electronic return in lieu of a paper return. The IRS conducted the first test of electronic filing in 1986, for a limited number of tax year 1985 returns. In 1990, the IRS permitted nationwide electronic filing of returns that had refunds owing. In 1991, the IRS accepted electronically filed returns that had balances due. In 1993, the IRS established an electronic filing goal of 80 million tax returns by 2001. During the 1997-filing season, the IRS received approximately 20 million individual tax returns electronically.

Current state law and programs, like at the federal level, provide the taxpayer with alternatives to paper returns. Taxpayers may choose to prepare returns themselves, purchase software to prepare returns or use the services of a tax preparer. There are currently two electronic filing methods for personal income tax (PIT) returns, Telefile and ELF.

For the Telefile program, FTB provides a free booklet, instructions and worksheet to PIT taxpayers who are eligible to file Form 540EZ (wage income only, no dependents, no itemizing). Taxpayers use FTB's toll-free number to phone in the tax return data. No form or paper is sent to FTB unless there is an amount due. In that case, the taxpayer mails the check with a voucher and incurs only cost of postage and envelope.

For the ELF program, more than 95% of all tax returns filed by individuals could be filed electronically (there are few restrictions, and even nonresident returns are included as of the 1997 tax year). No paper is sent to FTB unless there is an amount due. In that case, the taxpayer mails the check with a voucher and incurs cost of postage and envelope. The return may be filed in three ways under the ELF program:

- The taxpayer prepares his or her return using forms and instructions provided at no cost by FTB (direct mail, Internet, distribution sites). The taxpayer then pays a transmitter to transmit the return (fees range from $1 to $100).
- The taxpayer hires a preparer to complete and transmit the return.
- The taxpayer buys tax preparation software, prepares the return and for an additional fee, e-mails the return to the software provider for transmission to FTB.

Currently, 92% of all tax returns are filed on paper. FTB's current goals in moving to a paperless environment is to have 16% of PIT returns filed electronically by the year 2000 and 60% of PIT returns filed electronically by the year 2010. Electronic filing makes the processing of returns more efficient because electronically-filed returns usually are prepared using computer software programs with built-in accuracy checks, undergo pre-screening by FTB, and experience no key punch errors.

This provision would declare the Legislature's intent that paperless filing is the preferred form of filing and that by the year 2007, no more than 20% of all returns should be filed on paper.

Policy Considerations

This provision would raise the following policy considerations.

- Electronic filing benefits taxpayers by providing a convenient method to file returns, acknowledgement of receipt, more efficient processing and faster refunds. However, some taxpayers may resist filing by electronic methods, especially if they must incur costs (e.g., software programs, transmitter fees and computers) for filing electronically. In addition, some taxpayers may insist on filing paper returns due to the perception that "old-fashioned" filing makes it less likely that their return will be selected for audit.

- This provision would not require tax returns to be filed electronically and would not require payment to be received electronically or the department to transmit refunds electronically.

- Electronic filing may increase costs for secure transmissions to safeguard taxpayer information.

Implementation Considerations

To the extent this provision expedites FTB's current electronic filing goals, the following implementation considerations have been identified. Department staff is available to help the author resolve these concerns. Additional concerns may be found as staff continues to review this provision.

- Legislation may be required to impose an electronic filing requirement on taxpayers to achieve 80% participation.

- With the shift in the burden of proof, as provided in this bill, corresponding evidentiary changes may be required under current law to accommodate a paperless environment for administrative and court procedures for tax assessments.
- The department may need additional processing equipment to retain the return information for compliance purposes.

Technical Considerations

Amendment 4, provided at the request of the author's staff, would make the maximum paper return percentage consistent with the minimum electronic return percentage by applying both percentages to PIT returns.

Amendments 5, 6 and 7 would change "board" to "Franchise Tax Board."

LEGISLATIVELY MANDATED REPORTS

This provision would require the department to include in its annual report to the Legislature FTB's progress in meeting the goal of 80% of personal income tax returns filed electronically by year 2007 and any necessary legislative changes to assist FTB in meeting that goal.

FISCAL IMPACT

Departmental Costs

To the extent this provision expedites FTB's current electronic filing goals, additional costs may be incurred. However, operational savings may result from more efficient processing of returns filed electronically or by telephone.

Tax Revenue Estimate

This provision would have no impact to PIT and B&CT revenues.

4. SOL/Financially Disabled Taxpayers

EFFECTIVE DATE

This provision would apply to periods of disability before, on, or after January 1, 1999. However, this provision would not apply to any claim that is barred by the operation of any law or rule of law as of January 1, 1998.

SPECIFIC FINDINGS

Current federal law requires a taxpayer to file a claim for refund within three years of the filing of the return or within two years of the payment of tax, whichever period expires later (if no return is filed the two-year limit applies). A refund that is not filed within these time periods is rejected as untimely.

Current state law requires a taxpayer to file a claim for refund within four years from the due date (without regard to extensions) or one year from the date of payment of tax, whichever is later. In the case of a California waiver of the statute of limitations (SOL), the period for filing a claim for refund is the period of the waiver or one year from the date of overpayment, whichever is later. In the case of a federal waiver, the period for filing a claim for refund is six months from the expiration of the federal waiver.

Current state law requires the taxpayer to notify FTB if the amount of gross income or deductions reported to the IRS for any year is changed, either by the taxpayer or federal authorities. The taxpayer has six months from the final federal determination date to report the change to FTB. Claims for refund must be filed within two years from the date of the final federal determination.

Current state law allows taxpayers to file a claim for refund up to seven years after the due date of the return in the case of bad debts, worthless securities or erroneous inclusion of recoveries.

This provision would suspend the SOL for certain refund claims for a period where the taxpayer is “financially disabled.” The financial disability of an individual would be established through procedures and requirements of the FTB. A “financially disabled individual” is an individual unable to manage his or her financial affairs because of a medically determinable physical or mental impairment that is expected to result in death or to last for a continuous period of at least one year. An individual would not be financially disabled for any period that the individual’s spouse or any other person is legally authorized to act on that individual’s behalf in financial matters.

Policy Considerations

This provision would assist taxpayers with severe disabilities by allowing claims for refund after the normal statute of limitations has expired.

On the other hand, this provision would create an unlimited SOL for claims for refund allowing taxpayers with long periods of disability to make a claim even though evidence may have been lost through the passage of time.

Implementation Considerations

Implementation of the provision of this bill would occur during the department’s normal annual system update.

Technical Considerations

As requested by the author’s staff, Amendment 8 would include claims for refund based upon federal changes and bad or worthless debts or securities in this provision.

Amendment 9 would change “board” to “Franchise Tax Board.”

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue losses of $2 million for 1998-99 and $1 million for 1999-00. Revenue losses for 2000-01 would be minor, less than $500,000.

Tax Revenue Discussion

The revenue impact of this provision was based on federal projections.

Marion Mann DeJong
(916) 845-6979
Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1633
As Introduced January 5, 1998

AMENDMENT 1

On page 2, line 3, strikeout "board" and insert:

Franchise Tax Board

AMENDMENT 2

On page 2, line 9, strikeout "board" and insert:

Franchise Tax Board

AMENDMENT 3

On page 3, modify line 3 as follows:

know of, the extent of that understatement, and

AMENDMENT 4

On page 5, line 18, strikeout "board" and insert:

Franchise Tax Board

AMENDMENT 5

On page 5, modify line 16 as follows:

2007, no more than 20 percent of ~~all~~ personal income tax returns should be

AMENDMENT 6

On page 5, line 20, strikeout "board" and insert:

Franchise Tax Board

AMENDMENT 7

On page 5, line 24, strikeout "board" and insert:

Franchise Tax Board

AMENDMENT 8

On page 5, modify line 28 as follows:

The periods specified in Section 19306, 19308, 19309, 19311, and 19312 ~~and 19309~~,

AMENDMENT 9

On page 5, line 39, strikeout “board” and insert:

Franchise Tax Board